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No. 74-1471

In the Supreme Court of the United States

OCTOBER TERM, 1975

TSC INDUSTRIES, INC., ET AL., PETITIONERS

v.

NORTHWAY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

DAVID FERBER,
Solicitor to the Commission,

MICHAEL J. STEWART,
Assistant General Counsel,

THOMAS L. TAYLOR, III,
Attorney,
Securities and Exchange Commission,
Washington, D.C. 20549.

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The petition presents this case as involving the standard by which the materiality of omissions from proxy solicitation materials are determined for the purposes of Section 14(a) of the Securities Ex-

change Act of 1934, 48 Stat. 895, 15 U.S.C. 78n(a), and Rule 14a-9 promulgated thereunder, 17 C.F.R. 240.14a-9.[1]

In *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 431, the Court defined the objectives of Section 14(a) as follows:

> The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. The section stemmed from the congressional belief that "[f]air corporate suffrage is an important right

[1] Section 14(a) of the Act, provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

Rule 14a-9(a) provides:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

> that should attach to every equity security bought on a public exchange." H.R. Rep. No. 1383, 73d Cong., 2d Sess., 13. It was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders." *Id.*, at 14.

In accordance with the congressional mandate, the Commission has adopted proxy rules requiring that various items of information be set forth in solicitations for the votes of stockholders and has specifically provided in Rule 14a-9 that no proxy solicitation shall be made that "is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading * * *."

This Court articulated the test of materiality under the federal securities laws in *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384, and *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153-154. The courts of appeals, however, have questioned whether the test covers misstatements and omissions that "might" affect a reasonable shareholder's decision, or is confined to facts that "would" affect that decision. See, *infra*, pp. 12-13. Proper resolution of what is material is of direct and immediate concern to the Securities and Exchange Commission in the performance of its day-to-day responsibilities under the Act.

The standard of materiality under Section 14(a) and Rule 14a-9 must reflect the Act's purpose to protect investors by "resolving doubts in favor of

those the statute is designed to protect * * *" (*Mills* v. *Electric Auto-Lite Co.*, *supra*, 396 U.S. at 385) yet avoid any requirement that would clutter proxy statements with trivial information or facts unrelated to the interests protected by Section 14(a). *Id.* at 384. For the reasons set forth in this brief, the Commission believes that the appropriate standard, as enunciated in *Mills* v. *Electric Auto-Lite*, *supra*, is whether the misstatement or omission has a significant propensity to affect the judgment of a reasonable shareholder in the process of deciding how to vote. The Commission further believes that under any of the suggested tests the proxy statement involved in this case omitted facts without which it was materially misleading.

STATEMENT

This private damage action for alleged violations of Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a), and Rule 14a-9, promulgated by the Commission thereunder, involves a corporate takeover of TSC Industries, Inc., by the petitioner, National Industries, Inc. The respondent, Northway, Inc., was a shareholder of TSC at the time of the relevant transactions and sued derivatively in TSC's behalf in the United States District Court for the Northern District of Illinois. The district court denied respondent's motion for partial summary judgment (Pet. App. A31-A45). The court of appeals reversed, holding that ~~Northway~~ NATIONAL and TSC had violated Section 14(a) and Rule 14a-9 as a matter of law, and remanded for further proceedings.

1. National's acquisition of TSC was accomplished in two steps. The first step was the purchase in early February 1969, in a private transaction, of all of the TSC equity securities owned by Charles E. Schmidt and members of his family and a family foundation.[2] As a result, National became the owner of approximately 33 percent of the equity securities of TSC (App. 267). National then placed five nominees on the ten-member TSC board of directors, including Stanley Yarmuth, National's president, and Charles Simonelli, its executive vice-president (App. 267-268). Yarmuth and Simonelli subsequently became, respectively, chairman of the TSC board and chairman of TSC's executive committee (App. 48).[3] Of the five other directors, four were TSC employees (App. 268) and hence subordinates of Yarmuth, TSC's new chief executive and also chief executive of National.

On February 14, 1969, National reported to the Commission that "National [had] acquired approximately 33% of the outstanding voting shares of TSC, Inc. Accordingly, National may be deemed to be a 'parent' of TSC as that term is defined in the Rules

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[2] The complaint also alleged violations of Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, and alleged that the Schmidt family were aiders and abettors. The latter claims were resolved below in favor of the Schmidt defendants. The issues presently before this Court are confined to the claims under Section 14(a) against the corporate defendants.

[3] This, in effect, made Yarmuth chief executive officer of TSC (App. 445).

and Regulations under the Securities Act of 1933"[4] (App. 473, 490). TSC made a similar statement in its annual report to the Commission on Form 10-K, filed on February 27, 1969 (App. 509).

With its nominees installed on the TSC board, National proceeded with efforts to acquire the remaining 67 percent of TSC stock, which was publicly held. National formulated a proposed merger of TSC into National, under which the former would be liquidated, and its assets sold to National in exchange for a package of National convertible preferred stock and warrants for the purchase of National common stock. The National securities were then to be distributed to TSC shareholders in dissolution (App. 268).

The TSC board of directors apparently approved the proposal on October 16, 1969 (App. 265). Eight of the ten members of the board were present; four voted in favor of the merger and four abstained (three National nominees and one of the original TSC directors whose stock already had been sold to National in a separate transaction) (Pet. App. A22).

On November 12, 1969, the TSC and National boards jointly issued a proxy statement soliciting approval of the transaction by the shareholders of both companies. The merger proposal was recommended to the TSC shareholders as being in their best interest

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[4] Rule 405, 17 C.F.R. 230.405, adopted pursuant to the Securities Act of 1933, defines a "parent" of a specified person as "an affiliate *controlling* such person directly, or indirectly through one or more intermediaries" (emphasis added).

by both TSC's board of directors and its management (App. 259-267).

On motion for partial summary judgment, respondent asserted, *inter alia*, that there were material misrepresentations and omissions in the proxy solicitation with respect to the following three subjects of interest to shareholders:

1) The proxy statement failed to disclose recent purchases by National and a closely allied mutual fund of National's common stock, when price quotations for the common were given in the proxy statement as an indication of the value of the National offer.

2) The proxy statement emphasized an opinion rendered by the investment banking firm of Hornblower & Weeks-Hemphill, Noyes as to the fairness of the National offer to TSC shareholders, but failed to disclose a subsequent report by Hornblower reflecting unfavorably upon the value of the National warrants which were part of the package offered to TSC shareholders.

3) The proxy statement failed to disclose the positions in TSC held by National's president and executive vice president, and the reports that National and TSC submitted to the Commission that National may be deemed a parent of TSC for purposes of the Securities Act of 1933. These omissions were claimed to vitiate the objectivity of the proxy statement's recommendation to TSC shareholders that they approve the merger.

These omissions were alleged to be violations by TSC and National ("the corporate defendants") of Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a), and Rules 14a-3 and 14a-9 promulgated thereunder, 17 C.F.R. 240.14a-3 and 17 C.F.R. 240.14a-9.

2. The district court denied respondent's motion for summary judgment on the question of liability of the corporate defendants (Pet. App. A31-A45). It held that the test of materiality of the omissions was whether "the facts withheld were so obviously important to TSC shareholders that reasonable minds could not differ on the question of whether the shareholders might have considered them important" (Pet. App. A34, A38), but concluded that on the record as it stood, a trial was required to determine materiality.

On an interlocutory appeal, the court of appeals reversed the district court's denial of summary judgment on the liability of the corporate defendants. It held material under Rule 14a-9 the undisputed fact that the proxy statement failed adequately to disclose (1) the existing relationship of National and TSC, (2) the purchases of National's common stock by National and the allied fund, and (3) the qualification of the earlier opinion rendered by Hornblower & Weeks-Hemphill, Noyes with respect to the fairness of the exchange offer to the TSC shareholders. Since reasonable minds could not differ as to the question of materiality, it concluded that plaintiff was entitled to summary judgment (Pet. App. A7).

The court of appeals held, on the basis of *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384-385, and *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153-154, that "the proper test of materiality is whether the omitted fact is 'of such a character that it might have been considered important by a reasonable shareholder who was in the process of determining how to vote' " (Pet. App. A11-A12). It rejected a standard of materiality based upon whether the omitted fact could have " 'a significant *propensity* to affect the voting process,' " on the ground that "any test which does not require the inclusion of facts which *could* influence a reasonable stockholder would seriously undercut the intended prophylactic effect of these disclosure provisions" (Pet. App. A8, A9; emphasis in original). The court stated that "any test of materiality which requires a finding of some probability that the omitted fact would affect the voting process necessitates the same difficult proofs the Supreme Court sought to avoid [in *Mills* and *Affiliated Ute*, *supra*] by eliminating the need for independent proof of causation or reliance" (Pet. App. A10).

SUMMARY OF ARGUMENT

The Securities and Exchange Commission is of the view that the omissions from the proxy solicitation involved in this case are material under any of the interpretations by the lower courts of the standard of materiality declared in *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384-385, and reiterated in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153-154. It does not believe that the *Mills* opinion formulated

two different tests of materiality. Rather, under *Mills*, the criterion is whether the omitted facts have a significant propensity to affect the judgment of a reasonable shareholder in deciding how to vote. Under this standard, when material affirmative statements have been made, additional facts which qualify or undermine those statements must also be disclosed in order to insure that the affirmative statements are not misleading. The more stringent test suggested by the petitioner is unsuitable because it would deny the federal securities laws the flexibility that is essential for the proper protection of investors.

In this case, the affirmative statements concerning the value of National's stock and warrants, the role of National's officials on TSC's board of directors, and the control relationship between the two firms, were unquestionably material to the shareholders' decision whether to vote for the merger. The facts omitted were, therefore, also material because they were necessary to make the statements in the proxy solicitation not false or misleading.

Since the proxy statement set forth market price data for National's common stock and warrants, it should have disclosed facts about purchases of that stock by National and an allied mutual fund, which may have affected that data. Similarly, since the proxy statement emphasized an investment banker's opinion concerning the prices of the National warrants, it should also have disclosed the banker's subsequent advice that the market value of those warrants was expected to decline subsequent to the pro-

posed exchanges. Finally, the proxy statement did not adequately disclose the relationship between the management of TSC and National so that the stockholders could assess the objectivity of the strong recommendation which had been made by TSC's management and board of directors that the merger be approved.

Any one of these omissions provided a basis for liability as a matter of law. And certainly their total impact established materiality as a matter of law.

ARGUMENT

I

AN OMISSION OF FACTS IN A PROXY STATEMENT IS MATERIAL IF IT HAS A SIGNIFICANT PROPENSITY TO AFFECT THE JUDGMENT OF A REASONABLE SHAREHOLDER IN DECIDING HOW TO VOTE

In *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384-385, the Court held that proof that a misstatement or omission in a proxy statement is "material" is enough to establish a cause of action for violation of Section 14(a) of the Securities Exchange Act of 1934, and that there is no requirement of "proof of whether the defect actually had a decisive effect on the voting." The standard of materiality itself, the Court stated [*id.* at 384, emphasis in original]:

> embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.

> This requirement that the defect have a significant *propensity* to effect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

Two years later, in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, a case involving a suit for damages for alleged violations of the anti-fraud provisions of the Securities Exchange Act of 1934 growing out of failure to disclose certain facts in connection with the purchase of securities, the Court held that the plaintiffs were not required to prove that they had relied on the omissions. Citing the page of *Mills* containing the statement quoted above, the Court said that "positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. * * * This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact" (406 U.S. at 153-154).

The courts of appeals, however, have divided over whether the proper standard for determining materiality is whether the facts involved "would" or "might be" considered important by a stockholder. See *Smallwood* v. *Pearl Brewing Co.*, 489 F.2d 579

(C.A. 5), and *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (C.A. 2); see also the cases reviewed at Pet. App. A10, n. 13. In the present case the court of appeals concluded that the "might have" and "significant propensity" language in *Mills* constitute different standards from which different conclusions regarding materiality may result (Pet. App. A8-A9).

The Commission is of the view that the omissions involved in this case are material under any interpretation of *Mills* by the lower courts. ~~It also agrees with the court of appeals that the omissions involved in this case are material under the *Mills* standard~~. It sees no basis, however, for concluding that the *Mills* opinion formulated two different tests of materiality in the same paragraph.

To the contrary, it believes that *Mills* announced the following criterion for determining when facts omitted from a proxy statement are material: whether the omitted facts have a significant propensity to affect the judgment of a reasonable shareholder in deciding how to vote. We submit that this standard properly effectuates the purpose of Section 14(a) of the Act, and of the Commission's proxy rules, to ensure that shareholders have made available to them by management all the information that, in the circumstances of the particular case, they need in order to make an informed judgment on the proposal before them.

The more stringent test petitioners urge (Br. 24-27) is a reversion to the criterion for "materiality"

applied in actions for common law deceit. According to the ALI, *Restatement of the Law of Torts* § 538(2)(a) (1938), in such an action a fact is material if "its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question * * *."[5] Several courts of appeals have applied this common law standard to actions under Section 14(a) and Rule 14a-9. See, *e.g.*, *Gerstle* v. *Gamble-Skogmo, Inc.*, *supra*, 478 F.2d at 1301-1302; *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (C.A. 2); *Smallwood* v. *Pearl Brewing Co.*, *supra*, 489 F.2d at 604; *John R. Lewis Inc.* v. *Newman*, 446 F.2d 800, 804 (C.A. 5).

Whether or not those cases may have reached the correct results, the use of the common law tort standard is inconsistent with both *Mills* and *Affiliated Ute*. The federal securities laws are not limited to the standards of common law fraud and deceit; they are to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195. See *Affiliated Ute*, *supra*, 406 U.S. at 151; *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12. Just as any imposition of the common law standard of reliance was deemed to be inconsistent with the pur-

[5] The Court in *Mills* was fully familiar with § 538(2)(a), and decisions applying it in securities cases. 396 U.S. at 384, n. 6. Nevertheless, it expressly adopted the less restrictive formula.

poses of the federal securities laws in *Mills* and *Affiliated Ute*, the adoption in this case of the restrictive definition of materiality embodied in the *Restatement* would deny the federal securities laws the flexibility that is essential for the proper protection of investors.

The *Mills* standard that an omission of facts is material if it has a significant propensity to affect the judgment of a reasonable shareholder in deciding how to vote effectuates the congressional policy reflected in Section 14(a) that shareholders of publicly held corporations should receive all information they need in order properly to exercise their rights of corporate sufferage. The standard strikes the necessary balance contemplated by Congress between two competing considerations: (1) the need to insure that corporate management take adequate steps to communicate to the shareholders information relevant to the stockholders' exercise of their voting rights, which it uniquely possesses; and (2) the need to avoid furnishing large quantities of trivial information because of concern over possible liability resulting from failure to disclose all facts necessary to make the proxy solicitations not misleading.

Petitioners contend (Br. 20-21), however, that because the definition of "material" in the rule governing information that must be furnished in a registration statement[6] and in a rule governing other

[6] Rule 405(l) under the Securities Act of 1933, 17 C.F.R. 230.405(l). See, also, Rule 408, 17 C.F.R. 230.408.

filings under the Securities Exchange Act of 1934[7] is similar to that in Rule 14a-9, the standard of materiality we here urge would greatly expand the quantity and type of information required to be furnished in those other documents. The provisions to which petitioner refers, however, are qualified by requirements for disclosure of additional facts necessary to make admittedly material facts affirmatively disclosed not misleading.[8] The application of the Commission's test of materiality to this narrow but important category of information would not substantially increase the amount of information required in either registration statements or other filings or disclosures under the Securities Exchange Act of 1934. It would require only that where certain material affirmative statements have been made, additional facts which qualify or undermine those statements must also be disclosed in order to insure that the affirmative statements are not misleading.

The affirmative statements in the proxy solicitation concerning the value of National's stock and warrants that were being offered to TSC's shareholders in the merger, the role of National's officials on TSC's board of directors and the ~~stock~~ CONTROL relationship between the two firms, were unquestionably material to the shareholders of the two companies in deciding whether to vote for the merger. As we now

[7] Rule 12b-2(j) under the Securities and Exchange Act of 1934, 17 C.F.R. 240.12b-2(j). See, also, Rule 12b-20, 17 C.F.R. 240.12b-20.

[8] See n. 7, *supra*.

show, the facts omitted from the proxy statement were equally material because they were necessary to make the statements in the proxy solicitation not false or misleading.[9]

II

THE OMISSIONS IN THE PROXY STATEMENT WERE MATERIAL

A. The Proxy Statement Did Not Disclose Important Facts Concerning the Value of the National Securities Offered to the TSC Shareholders

1. The proxy statement represented that in approving the proposed merger, TSC's board of directors had considered recent market prices of the

[9] The factual setting in *Mills* was similar to the case at bar. The transaction for which shareholder approval was there sought was a merger of Electric Auto-Lite into Mergenthaler Linotype Company. The Auto-Lite directors recommended approval of the merger to shareholders without adequately disclosing the relationships of the Auto-Lite board and management to Mergenthaler, the acquiring corporation, and to American Manufacturing Company, which was apparently in control of both Auto-Lite and Mergenthaler. Even though "the proxy statement contain[ed] information which would indicate to those aware of corporate mechanism that Mergenthaler had the power to select a majority, if not all, the members of the board * * *," *Mills* v. *Electric Auto-Lite*, 403 F. 2d 429, 433 (C.A. 7), the proxy statement was held to violate Section 14(a) because the control relationships were not presented with as great emphasis as was given to the favorable recommendation of the board. *Id.* at p. 433. The *Mills* proxy statement had omitted to disclose that in connection with an application for exemption from the Investment Company Act of 1940, officials of American Manufacturing Company had represented that that company controlled the operation of both Mergenthaler and Auto-Lite.

tendered securities (App. 267). It also set forth market price data concerning National's common stock for the years 1967-1969 as well as for warrants to purchase that stock (App. 271). Management stated that it considered this market price data in recommending the merger (App. 267).

The proxy solicitation materials omitted to disclose, however, that purchases of National's common stock by National and by the Madison Fund, Inc., a mutual fund, together comprised 8.5 percent of the total volume of all transactions in that security on the New York Stock Exchange during the nine-month period between National's initial purchase of TSC stock from the Schmidt family and the proxy solicitation (App. 544-547).[10] The chairman of National's board of directors was also a Madison Fund director, and Edward Merkle, Madison's president—who caused Madison to purchase National's securities—was employed by National as a "consultant" at $12,000 per year (Pet. App. A18-A19 nn. 21, 22; App. 522).

These purchases and the relationships should have been disclosed so that the TSC stockholders could judge the extent to which the market prices empha-

[10] In eleven of the weeks in which the purchases were made, they exceeded 10 percent of the total volume and in one week during the period these purchases were 66 percent of the total volume (App. 544-547).

sized in the proxy material may have reflected something other than normal supply and demand.[11]

Accordingly, as the court of appeals held, it was not necessary to prove that there was collusion between National and the Madison Fund to manipulate the market in National's common stock in order to establish the materiality of these facts. The court of appeals correctly stated (Pet. App. A19):

> It was for the shareholders to determine whether the market price of the common shares was relevant to their evaluation of the convertible preferred shares and warrants, or whether the activities of Madison and National actually amounted to manipulation at all. This is the very purpose of disclosure.

While some figures, set forth in small type, concerning the cost of "shares of Common Stock purchased for treasury" could have been gleaned from a table entitled "Statements of Consolidated Stockholders' Equity," on pages 62-63 of the proxy statement (App. 323-324), these did not show when the purchases were made, other than that they occurred within a three and one-half year period. They were not comparable in prominence to the section entitled "Market Prices of Securities," appearing on page 10

[11] On July 19, 1972, the Commission suspended Mr. Merkle, Madison's president, from association with any broker-dealer for sixty days, based, in part, upon his having caused Madison Fund to purchase National securities without disclosing his salaried position with the company. See Securities and Exchange Commission Investment Company Act Release No. 7280 (1972) (App. 563).

(App. 271). Even a sophisticated investor who understood that this table reflected purchases by National of its own stock and who might have realized that the "treasury" purchases were in some way related to the market prices set forth at page 10, could not have made a proper analysis because the figures for treasury purchases were not broken down into 3-month periods as were the figures on page 10.

In any event, there was not even minimal disclosure of the purchases by the Madison Fund or of the relationship between that fund and National. Although recent market prices of the company's securities were required to be disclosed by Schedule 14A of the proxy rules, 17 C.F.R. 240.14a-101, this did not justify the failure of management to disclose with equal prominence market transactions by National and Madison Fund which necessarily affected these prices.

2. The value of the package of National securities offered to TSC shareholders was further distorted in the proxy statement by a misleading presentation of an opinion rendered by the investment banking firm of Hornblower & Weeks-Hemphill, Noyes. The proxy statement reported that (App. 267):

> At the request of TSC, the investment banking firm * * * rendered a favorable opinion as to the fairness to the stockholders of TSC of the terms, set forth below, * * *. * * * In such opinion, said firm considered, among other things, the current market prices of the securities of both corporations * * * [and] the substantial premium

> over current market values represented by the securities being offered to TSC stockholders * * *.

As we have noted, the statement prominently set forth recent market prices. These included the prices of the National warrants.

This data was materially misleading because it did not disclose that the Hemphill, Noyes firm had subsequently advised management that it expected that the market value of the National warrants included in the package would decline substantially subsequent to the proposed exchange. As the court of appeals noted, "TSC and National had received some good news and some bad news from the Hornblower firm. They chose to publish the good news and omit the bad news" (Pet. App. A17). These materially misleading representations are precisely the type of unfair corporate communication against which the proxy rules are intended to protect shareholders.

B. The Proxy Statement Did Not Adequately Disclose the Relationships Between the Management of the Companies that Showed the Influence of National Upon TSC's Management

TSC's management, which had a fiduciary relationship to its shareholders, could not properly advise its shareholders to approve the merger without also revealing the facts showing the influence of National upon TSC's management. Where a proposed corporate transaction involves dealing with an outside entity, as in a proposed sale of the corporate assets or a merger, any existing relationship between that

entity and the corporation that is likely to influence the latter's attitude toward the transaction is highly significant to shareholders asked to approve the proposals. For shareholders are entitled to assume that the recommendation of their board of directors is objective. It is therefore misleading when, as here (App. 259), the management and board of directors of a company make a strong recommendation to its stockholders, who are deciding how to exercise their corporate suffrage, without disclosing to the stockholders the interest of those making the recommendation.

To be sure, the proxy materials issued in connection with the National acquisition disclosed that five of the directors of TSC were nominees of National (App. 267-268), and that National owned a 33 percent equity interest in TSC (*ibid.*). Adequate disclosure must be such, however, that an ordinary investor, not merely a sophisticate, may understand the truth.[12] Whether or not National actually controlled TSC at the time of the proxy solicitation, shareholders were entitled to know that the two companies had previously told the Commission that "Na-

[12] *Surowitz* v. *Hilton Hotels Corp.*, 342 F. 2d 596, 602 (C.A. 7), reversed on other grounds, 383 U.S. 363; *United States* v. *Monjar*, 47 F. Supp. 421, 425 (D. Del.), affirmed, 147 F. 2d 916 (C.A. 3), certiorari denied, 325 U.S. 859. The Commission has for many years applied this principle in its administrative decisions. See *In the Matter of Axe Securities Corporation*, 42 S.E.C. 381, 383; *In the Matter of The Private Investment Fund for Governmental Personnel, Inc.*, 37 S.E.C. 484, 487; *In the Matter of Universal Camera Corp.*, 19 S.E.C. 648.

tional may be deemed to be a 'parent' of TSC" in accordance with Commission rules that define "parent" in terms of "control" (App. 473, 490, 509, 512, 517), so that they could assess the significance of that relationship as the corporations themselves understood it.[13]

Moreover, the significance of National's influence would further have been emphasized by disclosure of the facts that National's president is chairman of TSC's board of directors and that National's executive vice-president is chairman of TSC's executive committee—facts which were not set forth in the proxy statement.

Accordingly, without these disclosures, the purportedly objective recommendation of management was materially misleading.[14]

[13] Resolution of the issue of adequate disclosure of the relationship between National and TSC does not turn, as petitioners suggest (Br. 6), upon an affirmative factual determination that, at the time the proxy statement was issued, National was or was not in control of TSC. The court of appeals recognized that the disclosure problem presented here with respect to control relationship is different.

> We agree with the district court that the issue of control is a factual issue presently in dispute and that summary judgment as to the Rule 14a-3 claim would have been inappropriate. * * *
>
> Plaintiff's Rule 14a-9 motion for summary judgment is quite different * * *. [Pet. App. A6.]

[14] Petitioner seems to suggest (Br. 28-29) that the disclosure in the proxy solicitation materials should be deemed adequate because prior to dissemination to stockholders, these materials were submitted to the staff of the Commission for

While liability can be predicated on any one of the foregoing omissions, there can be no question that their total impact bears significantly on the purported objectivity of the advice that the TSC management gave its stockholders that the merger was in their best interest. Accordingly, and without reaching disputed facts such as the existence of actual collusion in the market purchases or actual control of TSC by National, the court of appeals correctly determined that the omissions were material as a matter of law.

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comment. Of course, certain of the omitted facts could not have been known to the Commission's staff when it reviewed the proxy materials. In any event the Commission's Rule 14a-9(b), 17 C.F.R. 240.14a-9(b) provides:

> The fact that a proxy statement * * * has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein * * *.

See *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432: "The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited." In the Commission's fiscal year 1970, when the TSC solicitation took place, 5,595 proxy statements were submitted for review by the Commission's limited staff. See, Thirty-Sixth Annual Report of the Securities and Exchange Commission, p. 46 (1970).

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

DAVID FERBER,
Solicitor to the Commission,

MICHAEL J. STEWART,
Assistant General Counsel,

THOMAS L. TAYLOR, III,
Attorney,
Securities and Exchange Commission.

JANUARY 1976.

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1968 1969 1970

NII COMMON STOCK

NII PREFERRED STOCK
$1.25 SERIES B

NII WARRANTS

* COMMON STOCK TRADED ON AMEX FROM JAN. 1968 - JULY 1968. ** JULY 2, 1968 NII LISTED ON NYSE.

JANUARY 1968 FEBRUARY MARCH APRIL MAY JUNE JULY AUGUST SEPTEMBER OCTOBER NOVEMBER DECEMBER JANUARY 1969 FEBRUARY MARCH APRIL MAY JUNE JULY AUGUST SEPTEMBER OCTOBER NOVEMBER DECEMBER JANUARY 1970 FEBRUARY MARCH APRIL MAY JUNE JULY AUGUST SEPTEMBER OCTOBER NOVEMBER DECEMBER

TOTAL NUMBER OF NII COMMON STOCK TRADED

TOTAL NUMBER OF NII COMMON STOCK PURCHASED BY MADISON FUND

TOTAL NUMBER OF NII COMMON STOCK PURCHASED BY NII

557,600 268,500 194,900 442,900 512,700 317,900 287,800 150,500 196,100 313,700 418,500 484,500 316,500 176,600 150,300 168,600 206,200 153,900 149,300 138,700 184,400 226,300 178,600 272,700 128,200 73,700 71,900 91,200 117,900 78,500 59,300 57,900 113,900 57,600 66,300 167,900

2

1968
Madison Fund Purchases
as Percent of Weekly Volume

1969
Madison and National Purchases
as Percent of Weekly Volume

Purchases as Percent of Weekly Volume

Purchases as Percent of Weekly Volume

NII COMMON STOCK

NII PREFERRED STOCK $1.25 SERIES B

NII WARRANTS

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS

NORTHWAY, INC.)
v.) No. 69 C 2513
TSC INDUSTRIES, INC.)

EXHIBIT A TO REPLY BRIEF OF PLAINTIFF
IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT
AS TO LIABILITY OF CORPORATE DEFENDANTS

Note: Chart underneath transparent plastic is Exhibit to Brief of Corporate Defendants. Overlay is based on Charts A and B and Notes thereto attached to Plaintiff's Main Brief.

Upper Portion: Bar Chart shows Madison and National Purchases as Percent of Weekly Volume (BLUE LINES)

Lower Portion: Significant Events. (Letters in parentheses refer to Notes to Charts A and B) (RED LINES)

(A) 1-20 NII purchases Susskind's stock at price over market

(B) 1-30 NII deal to acquire Schmidt stock

(C) 2-3 NII acquires option on Crescent stock

(D) 2-22 Initial Madison Fund purchase of NII Common

(E) 3-25 Crescent votes to merge with NII

(F) 4-22 NII proposes merger of NII and Cott

(G) 4-25 NII Crescent Proxy Statement mailed

(H) 5-3 & 5-10 Valuation period of NII Common for Crescent transaction. Madison buys heavily. NII Common rises sharply.

(I) 5-17 to 6-18 Madison continues purchases of NII Common. 6-20 Crescent and Cott stockholders approve merger.

(J) 7-5 NII acquires 53% of Hawthorn-Mellody

(K) 9-3 NII proposes merger with Hawthorn-Mellody

(L) 9-20 & 9-27 Valuation period of NII Common for Hawthorne-Mellody transaction. Madison makes substantial purchases of NII Common.

(M) 10-1 Hawthorn-Mellody Proxy Statement mailed

(N) 10-1 NII raises salary of Merkle, President of Madison

(O) 10-3 NII offers convertible debentures. Madison buys $2,000,000 of debentures.

(P) 10-13 Acquisition plan publicly announced. 10-16 TSC directors purport to approve plan.

(Q) 10-7 Newspaper reports of NII acquisition of TSC. Madison buys NII Common preceding and following announcement.

(R) 8-25 to 8-29 Valuation period for NII Common re Nelson Sales deal. NII buys NII Common. Price rises.

(S) 8-15 NII reports poor first half results. On 8-11 NII buys 2,800 shares of NII Common.

(T) 6-26 NII buys NII Common over market

(U) 6-18 Hawthorn-Mellody Retirement Fund buys NII Common

(V) 5-16 NII reports poor first quarter earnings. On 5-15 NII buys NII Common.

(W) 4-7 NII Common falls to 1969 low. Madison buys NII Common throughout week.

(X) W/E 3-28 NII buys NII Common over market